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COMMENTS TO AMENDMENTS TO GAS VALUATION REGULATIONS FOR FEDERAL LEASES

On April 17, 1997, the Minerals Management Service requested comments on a number of matters concerning the possible change of its regulations with regard to the valuation of natural gas for royalty purposes. 62 F.R. 19536, April 22, 1997. The period of time in which to offer comments was extended until September 22, 1997. The following represents National Fuel Corporation's comments.

1. The proposed X-Factor Method and Norway Method for setting royalty prices. (Artificial Methods)

   a. Lessons from the 1970s oil and gas pricing regulations.

      i. Governmental artificial pricing methods always distort the free market and often the industry itself. When businesses make business decisions based on what their best economic reality is under a set of regulations rather than what is happening in the market, both prices and the industry become distorted. Such pricing methods always have unintended results. An example of unintended results of the 1970s crude oil pricing regulations was the demise of the small refiner and the consolidation of refining capacity into a limited number of large refineries. This consolidation has ramifications today. Many other parts of the 1970s pricing regulations have provided similar unintended results.

ii. When artificial pricing methods are in place, political agendas--not the market--set the price. Both the market and artificial pricing methods will always be "inequitable" to one part or other of an industry. The difference is that the market is unbiased and unchangeable. Artificial pricing methods are changeable, and people politically try to amend the regulations to their advantage. Some changes are inevitable to meet inequitable and unintended results. The history of the 1970s pricing regulations has shown that the regulations will become more and more complex and more and more expensive to administer. Finally, such regulations become so complex as to be unadministrable.

b. Some obvious unintended results of the Artificial Methods.

i. One of MMS' stated reasons for going to the Artificial Methods is that oil companies in the modern market find it too hard and expensive to use the net proceeds method of valuation and the MMS finds it too expensive and complex to audit those calculations. Assuming producers are given a choice of the method of calculation, business men will still have to make a gross proceeds calculation. It is the only way to determine which method of calculation is the least expensive to the producer. MMS's expenses will probably not diminish either, but only be shifted to a different arena, such as trying to determine the X factor and defending that against those injured by that decision. It is doubtful there will be savings for either the industry or the MMS.

ii. It will not be very long before a comparison will be made between the amount received by the MMS using the producer option method of valuation and the value that would be received if all gas was uniformly valued at the Artificial Method. Because of the delay in setting any artificial price based on past performance, when the demand exceeds supply, valuation under the gross proceeds method of calculation will exceed the index price and the producer will use the Artificial Method. The opposite will be true when the supply exceeds demand. When the demand exceeds supply and producers elect to use gross proceeds method, then the government will feel it was cheated and there will be a demand to eliminate the option and value all royalties on the basis of the Artificial Method. If the artificial price method becomes mandatory, and since independents generally receive less than index, the independents would be at an even greater competitive disadvantage. The independents would have to pay a penalty which would be the difference between gross proceeds and the artificial price, while the big oil companies will reap a windfall because they can get a price above the artificially set price. This would have several ramifications, not the least of which would be the increased cost of production, the end result of which would be the premature abandonment of wells.

iii. The MMS has stated that it does not believe that the indices are representative of gross proceeds. In macro, the indices are the market price, and they are relied upon by the industry to make business decisions. They are a valid indicator of the value determined by a willing buyer and a willing seller, but not every sale is going to be at index price. In the micro, the index price is the starting place for setting a sale price. For the producer, negotiations depend on a lot of different factors: volume to be sold; proximity to gathering systems, intrastate and interstate pipelines; proximity to buyer; Btu content; contaminants content; reserves; length of contract; dependence on third party aggregators; and many other factors. Equally complex are needs of the purchaser. Generally, big oil companies have a competitive advantage in receiving above index price over the small independents for a number of obvious reasons. With the advent of an artificially set price, big oil company's competitive advantage could generally be expected to drive the price of gas artificially upward as the big oil companies try to stay above the artificial price set by MMS. The disadvantage to the independent will be having to continue to use the gross proceeds method of calculation, with its attendant costs. Additionally, it can be expected that buyers will try to drive the independents' price down to overcome their higher costs from big oil.

iv. The MMS's study has found that the average price under gross proceeds method of valuation exceeds the index price. Any average means there are some producers who are selling for less than the index price and some for more. It can generally be conceded that it is the independent that is selling for less than the index price. However, whether the gross proceeds method of valuation will be greater than the index price is dependent on many factors, including weather, demand supply, pipelines available, and many other factors.

c. Norway Method - Not a comparable method of evaluation.

i. Norway's oil production is off shore. Producers are big companies; there are no small independents.

ii. Oil is produced under a license from the government. Those licenses may permit such valuation of royalty. It is questionable whether or not federal oil and gas leases, which were issued and accepted many years ago, would contractually permit royalty valuation determined without reference to actual value.

iii. The worldwide market for oil is inherently very different from the United State natural gas market. In the worldwide crude oil market, there are relatively limited numbers of producers and marketers. The worldwide market is not truly a free market. It is an oligopoly, in large part controlled by the production of Saudi Arabia. It is a much more stable market and not as subject to the instantaneous vagaries of the weather.

d. X-Factor

i. The MMS studies show that it will have a loss of $20 Million Dollars if pure index prices are used. This number needs to be compared to the estimated cost of enforcing and implementing the X-Factor. It should be considered whether or not it is more cost effective to just accept the loss and spend less on government intervention.

ii. The X-Factor is based upon last year's numbers. The dynamics of the gas market change faster than once each year. The price for gas changes quickly and dynamically, mostly upon an unknown factor: the weather. For example, last year's weather may have been warm and this year's very cold. Last year's X adjustment could be negative. If this year was particularly long and cold, demand would exceed supply and gas would sell above index. Under such circumstances, the MMS will receive less than gross proceeds. When the weather factors are the opposite, the producer will pay a penalty. It is not necessarily true that they will even out over a number of years.

2. Mandatory use of artificially set prices.

a. In its Report and Analysis dated February 6, 1997 on page 3, the MMS made the following statement:

> A. The rule provides additional options to lessees in the valuation of gas sold under arm's-length sales contracts and under non-arm's-length sales contracts in areas with an active spot market. Specific provisions address:
>
> .conditions under which lessees selling gas under non-arm's-

length contracts may use either published gas price indices or affiliates arm's-length gross proceeds in establishing value for royalty purposes;

b. This is an example of unintended results. National Fuel has an affiliated marketing company, which also markets gas for other companies. National Fuel's affiliated marketing company is believed to be one of the three largest marketing companies on the Western Slope of Colorado. National Fuel formed this marketing entity because it did not believe that it was getting the best price for its gas. The marketing company competes for National Fuel's gas just like any other company. If the marketing company has the best price, it gets to market National Fuel's gas. If it does not, National Fuel sells to some other marketer. Generally speaking, the marketing company gets to market National Fuel's gas because it can give National Fuel a better price than a third party marketer. This arrangement also results in a greater royalty for the government. However, the marketing affiliate has operating costs that must be incurred to get that greater price.

National Fuel has contractual obligations with it non-operating working interest owners, which does not allow National Fuel to profit by self-dealing. The non-operating working interest owners monitor National Fuel closely for any such self-dealing, effectively doing MMS' audit for it. The appearance of impropriety should never be construed as an actual impropriety. As can be clearly shown by this example, what MMS perceives as an appearance of impropriety, is actually a benefit to MMS and not impropriety at all.

From the above statement, it is assumed that like the November 5, 1995 proposed rule making, the MMS, if it adopted one of the Artificial Methods, would require National Fuel to either use the artificial price or pay royalty on the basis of the sale price of the marketing entity.

c. Generally, National Fuel sells gas, no matter the entity to which it sells, at a price less than index. There are many reasons for this, but that is the norm in this producer's location. If the proposed regulation requires National Fuel to pay royalty based upon either the artificial price or at the marketing arm's price, then National Fuel would probably not sell to its marketing arm. Such a sale would be less than National Fuel might get from its marketing company, with the resultant lower royalty, but it would be arm's-length.

d. Again, unintended results. First, MMS would receive a royalty of less than it could receive otherwise. Second, the purpose of FERC Order 636 was to open up the gas marketing and transportation system of this country. The second unintended result would be to create a dis-incentive for any small producer to market its own gas and to allow the continued consolidation of marketing and distribution into the hands of a few companies, which was exactly what FERC Order 636 attempted to break up.

3. Recommendations

a. If the MMS is determined to use some form of Artificial Method of valuation, then do a comparison study between the costs of using some other valuation and the index. The MMS will probably find that the cost to the MMS of using the index will be *de minimis*. If the cost of the MMS's checking the industry's calculations is included, it will be even less.

b. MMS has the option of taking its gas in kind. With that kind of volume, such royalty gas would probably sell above index. An alternative would be to take just some of its gas in kind and run test sales to see what really is the market.

c. If a small producer with an affiliate marketing company can show that other bids were solicited and the affiliate's price was the best, then that price becomes in effect an arm's-length transaction.

d. Keep the point of value at the wellhead.

Respectfully submitted,

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